The opinion of the Court of Appeals is unreported to date. That opinion and the judgment of said Court are printed in the Appendix, *infra*.

JURISDICTION

The judgment sought to be reviewed is that of the United States Court of Appeals for the Ninth Circuit filed and entered April 2, 1959 (R. 314). Jurisdiction to review said judgment upon writ of certiorari is conferred upon this Court by Section 1254(1) of Title 28 of the United States Code and Section 7482(a) of the Internal Revenue Code of 1954.

QUESTION PRESENTED

The pivotal question is whether the Commissioner of Internal Revenue, without warrant in law, made an allocation of income to a partnership, of which petitioner, Alden Charles Palmer, was a member.

STATUTES INVOLVED

The pertinent parts of Sections 41 and 42(a) of the Internal Revenue Code of 1939 are as follows:

Sec. 41. General rule.—The net income shall be computed upon a basis of the taxpayer's accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the

computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income.

Sec. 42. Period in which items of gross income included.

(a) General rule.—The amount of all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under Section 41, any such amounts are to be properly accounted for as of a different period.

STATEMENT OF THE CASE

August 20, 1947, Santa Anita Square, Inc. (called Santa Anita), was incorporated to engage in the business of acquiring and developing land for residential purposes (R. 102); and it acquired Tract No. 13613 in Los Angeles County, California, which it subdivided into lots numbered 1 through 160 (R. 11).

September 5, 1947, A. C. Palmer & Company, a limited partnership (called partnership), was formed to engage in the building and construction business, and it was composed of the petitioner, Alden Charles Palmer, as general partner, and four limited partners (Ex. 1).

September 20, 1947, the Board of Directors of Santa Anita adopted a resolution to borrow, from the Bank of America National Trust & Savings Association (called Bank of America) the sum of $1,296,000.00, the proceeds to be used for the construction of off-site street improvements and 160 dwellings and improvements incidental thereto on the aforesaid 160 lots (R. 12, 13, 97; Ex. 3).

October 29, 1947, the partnership entered into a written contract with Santa Anita to construct a residential structure with improvements incidental thereto upon each of the said 160 lots for a fixed and firm contract price in the aggregate amount of $1,428,389.00 (R. 14, 15, 116; Ex. 2). Articles 4 and 5 of the contract are pertinent, as follows:

Article 4. Progress payments—The Owner shall make payments on account of the Contract, as provided therein, as follows: On or about the tenth day of each month one hundred per cent of the Contractor's cost of labor and materials incorporated in the work and of materials suitably stored at the site thereof up to the last day of the preceding month, as established by evidence satisfactory to the Owner, less the aggregate of previous payments.

Article 5 (first paragraph). Acceptance and final payment—Final payment shall be due 35 days after substantional completion of the work provided the work be then fully completed and the Contract fully performed.

To obtain borrowed funds to construct or have constructed the dwellings and improvements, Santa Anita was required by the Bank of America to, and it did, execute Owner-Builder agreements (Ex. 11); also Owner-Builder construction control agreements to satisfy the Bank of America that funds borrowed from it by Santa Anita would be disbursed through Builders' Control Service (Ex. 11). The partnership was required to, and it did, execute lien waivers (Ex. 13).

It was stipulated that as of August 31, 1948, all limited partners sold their interest in the partnership to petitioner

for the amounts of their original investments; that as of September 1, 1948, the partnership assets, including the contract with Santa Anita, were transferred to A. C. Palmer and Company, a corporation, incorporated on September 1, 1948 (called Palmer & Company); and that petitioner received shares of common stock of Palmer & Company in exchange for the assets he transferred to it (R. 104).

It was also stipulated that by September 1, 1948, the date of the liquidation of the partnership,[1] 80 houses were completed, escrows of sales were open on 95 houses, escrow sales were closed on seven houses, and the foundation for all houses were completed and approved by the Federal Housing Authority (R. 106).

Palmer & Company was not a party to the contract between the partnership and Santa Anita as originally drawn, and it was not drawn to bind assignees (Ex. 2). Palmer & Company assumed the liability (R. 228).

Also on September 1, 1948, petitioner and the other stockholders of A. C. Palmer Construction Company, Oklahoma (called Oklahoma corporation) exchanged their shares of stock in the Oklahoma corporation for shares of preferred stock in Palmer & Company (R. 104), and the Oklahoma corporation thusly became wholly owned by Palmer & Company (R. 29).

The Santa Anita Square project* was completed during Palmer & Company's fiscal year ended August 31,

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[1] Liquidation is a question of fact. *John Milton* v. *Commissioner*, 33 B.T.A. 4, 8. In California, dissolution represents the demise of a partnership, and liquidation the settlement of the estate. *Maryland Casualty Co.* v. *Little*, 282 Pac. 968, 971. On September 1, 1948, the partnership was without partners, an asset or a liability; it was an extinct entity.

* Designated name of the real estate development.

1949, about 10 or more months after the partnership's demise (R. 137, 143). For the fiscal year ended August 31, 1949, Palmer & Company filed a consolidated return with its subsidiary, the Oklahoma corporation, and Palmer & Company there reported for taxation the profit from the Santa Anita Square project, off-set in part by a net loss of the Oklahoma corporation (Ex. D).

A first and final return for the partnership was filed on the cash basis for the period ending August 31, 1948, in which was reported no profit from the Santa Anita Square project (Ex. C).[2]

The Commissioner computed a profit from the Santa Anita Square project of $168,930.14, allocated $128,090.43 thereof to the partnership, and treated $108,876.87 as being petitioner's distributive share (R. 6, 7, 293).[3]

By virtue of authority vested in him by Section 272(a)(1) of the Internal Revenue Code of 1939, the Commissioner mailed petitioners a notice of deficiency on March 6, 1952, asserting a deficiency of $76,517.63 in federal income tax for the calendar year 1948, predicated principally upon an allocation of a part of the profit from the Santa Anita Square project to the partnership of which petitioner Alden Charles Palmer had been a member (R. 3-8). A petition for a redetermination of the deficiency was filed with the Tax Court (R. 3). After a hearing (R. 56), the

[2] "Construction in Progress", $961,900.42, appearing as an asset in the balance sheet of the partnership return, was the property of Santa Anita and not a partnership asset.

[3] A revenue agent testified the allocation was made on the basis of the actual amount expended by each entity, the partnership and Palmer & Company (R. 287).

Tax Court sustained the Commissioner, and entered its decision (R. 49, 50). Upon review, the Court of Appeals affirmed the decision of the Tax Court (R. 313), and entered its judgment (R. 314).[4] Said judgment, by Section 7482(a) of the Internal Revenue Code of 1954, is made subject to review by this Court in the manner provided in Section 1254 of Title 28 of the United States Code.

SPECIFICATION OF ERRORS TO BE URGED

The Court of Appeals erred as follows:

1. In failing to recognize and give effect to a novation.

2. In dealing with two contracts as one long-term contract.

3. In failing to find and hold that the partnership was liquidated on September 1, 1948.

4. In failing to apply California law with respect to dissolution and liquidation of a partnership.

5. In failing to recognize properly the force and effect of a contingency in the contracts in respect of the final payment.

6. In upholding the Tax Court in sustaining the action of the Commissioner in allocating to the partnership

[4] The court below mistakingly says the contract was transferred by the partnership. The findings of the Tax Court are that on August 31, 1948, petitioner acquired the partnership interests of the limited partners, and that on the next day, September 1, 1948, 200 shares of common stock of Palmer & Company were issued to the petitioner for the assets of the partnership (R. 28, 29). The stipulation shows the partnership assets included the contract with Santa Anita (R. 104).

a portion of the final payment received by Palmer & Company under its contract with Santa Anita.

7. In failing to find and hold that the partnership realized no taxable income under its contract with Santa Anita.

8. In relying upon cases that are factually distinguishable, and not controlling.

Remark: Specification of Errors 1 through 7 appear as statement of points in the court below, verbatim or in substance (R. 54, 55).

REASONS RELIED ON FOR GRANTING THE WRIT

I

This case involves important questions of federal law which have not been, but should be, settled by this Court.

Argument

In sustaining the determination of the Commissioner, the Tax Court applied Sections 41 and 42(a) of the Internal Revenue Code of 1939 (R. 36-46). In affirming the decision of the Tax Court, the court below majored on method of accounting covered by Section 41. We submit that allocation of income between two distinct legal entities is not a method of accounting at all, and is as much a technique as the net worth technique recognized by this Court in *Holland* v. *United States*, 348 U.S. 121, 131.

The court below should have majored on that part of Section 42(a) which provides that the amount of all items of gross income shall be included in the gross income

for the taxable year in which received by the taxpayer. We submit that there is nothing in Section 42(a) from which the intent of Congress can be drawn that an item of gross income, which constituted an indebtedness of Santa Anita to Palmer & Company and which was paid to Palmer & Company, must be accounted for by the partnership in part. We further submit that Section 42(a) is designed to permit nothing more than the shifting of an item of gross income from the taxable year in which received by a taxpayer to a different taxable year of the same taxpayer, if the method of accounting employed by such taxpayer does not reflect his income.

The final payment, an item of gross income, constituted the profit from the Santa Anita Square project, since the progress payments covered and included only the actual cost of the labor and materials incorporated in the work and suitably stored at the site, giving rise to no profit as the work progressed. The making of the final payment depended upon fulfillment of a contingency. Fulfillment occurred some months after the partnership had become extinct. The final payment was made to and received by Palmer & Company upon fulfillment of the contingency by it.

There is a distinction between a debt and a contract for a future indebtedness to be incurred, provided the contracting party perform the agreement out of which the debt may arise. *Walla Walla* v. *Walla Walla Water Co.*, 172 U.S. 1, 20. The contract (Ex. 2) provided for the creation of a future indebtedness in the form of a final payment to be made only on condition that the work be fully completed and the contract fully performed. The partner-

ship had not completed its contract at the time of its dissolution and liquidation and the transfer of the partnership assets by petitioner to Palmer & Company for shares of its stock. Unconditional liability of Santa Anita to make the final payment arose during the fiscal year of Palmer & Company ended August 31, 1949. *Cf. Lucas v. North Texas Lumber Co.*, 281 U.S. 11. Consequently, the partnership never became entitled to the final payment or to any part of it, nor did Santa Anita ever become indebted to the partnership therefor, according to the reasoning of this Court in *Walla Walla v. Walla Walla Water Co.*, 172 U.S. 1, 20.

In *Lucas* v. *Earl*, 281 U.S. 111, *Helvering* v. *Horst*, 311 U.S. 112, and *Helvering* v. *Eubank*, 311 U.S. 122, this Court held "that one vested with the right to receive income did not escape the tax by any kind of anticipatory arrangement", according to *Harrison* v. *Schaffner*, 312 U.S. 579, 582. The partnership never became vested with the right to receive the final payment.

Money is certainly property. *Pirie* v. *Chicago Title & Trust Co.*, 182 U.S. 438, 443. While status of property with respect to ownership is determined by state law, federal tax liability with respect thereto is determined by federal law. *Morgan* v. *Commissioner*, 309 U.S. 78, 80.

The questions are:

Is allocation of income between two distinct legal entities a method of accounting or a technique?

Is a legal entity chargeable with any part of an item of gross income payable only upon complete performance

of a contract in circumstances where the entity is dissolved and liquidated prior to completion and where a distinct legal entity assumes liability, completes performance, and receives the contingent item of gross income?

Does assumption of liability by a legal entity to complete performance of a partially completed contract create a new contract in circumstances where said entity completes the contract, receiving progress payments and the final payment called for by the contract?

These questions are important to the proper administration of the federal income tax laws, for Section 41 and Section 42(a) in the 1939 Code appear as Section 446(a) and (b) and Section 451(a) in the Internal Revenue Code of 1954. These questions have not been decided by this Court, and should be.

II

The court below failed properly to apply income tax law to basic legal rights.

Argument

Allocation of income is chiefly a matter of the application of income tax law to basic legal rights, and so recognized by the court below in quoting this principle from *Jud Plumbing & Heating, Inc.* v. *Commissioner*, 153 F.2d 681, 685 (R. 311). The partnership had no basic legal right to any part of the final payment made to and received by Palmer & Company, because the partnership had failed to complete its contract with Santa Anita, and had executed lien waivers. Palmer & Company assumed the liability; it was not a party to the contract as originally

drawn, and it was not drawn to bind assignees. Without the final payment, there was no taxable income, the progress payments giving rise to none. We submit that an action against Palmer & Company or Santa Anita by the former partners for any part of the final payment would have been fruitless. In *Hoeper* v. *Tax Commission of Wisconsin*, 284 U.S. 206, 215, this Court says that which is not in fact the taxpayer's income cannot be made such by calling it income. Income means gains and profits; and having regard to the very truth of the matter, the partnership never became entitled to anything that answers the definition of income within the meaning of the Sixteenth Amendment. *Cf. Eisner* v. *Macomber*, 252 U.S. 189, 207, 211. The final payment was the property of Palmer & Company, and was so treated by it. Aside from all other reasons advanced that no part of the final payment was partnership income, the claim of right doctrine announced by this Court in *North American Oil Consolidated* v. *Burnet*, 286 U.S. 417, 424, made the whole of the final payment taxable to Palmer & Company. We submit that the court below failed to apply income tax law to basic legal rights.

III

The court below has decided a federal question of law in conflict with applicable decisions of this Court.

Argument

In *H. Hackfeld & Co.* v. *United States*, 197 U.S. 442, 447, this Court says "We think the parties were entitled to have this case tried upon the assumption that these ultimate facts, stipulated into the record, were established

no less so than the specific facts recited." Ultimate facts stipulated into the record here show the partnership was liquidated on September 1, 1948. No mention is made of the liquidation in the opinions below; mention is made of the dissolution. This Court in *Bogardus* v. *Commissioner*, 302 U.S. 34, 41, gave effect to the facts stipulated.

The partnership had a tax identity distinct from Palmer & Company, *Moline Properties, Inc.* v. *Commissioner*, 319 U.S. 436, 437-440, and so recognized by the Commissioner in making his allocation.

In drafting a contract the parties have the right to select their own criteria. *Barreda* v. *Silsbee*, 62 U.S. 86, 91. It is a matter of great public concern that freedom of contract be not lightly interfered with. *Steele* v. *Drummond*, 275 U.S. 199, 205.

A party may avail himself to the full of what the law permits. *Bullen* v. *Wisconsin*, 240 U.S. 625. The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, cannot be doubted. *Gregory* v. *Helvering*, 293 U.S. 465, 469.

This Court in *United States* v. *Merriam*, 263 U.S. 179, 187, 188, says that "in statutes levying taxes the literal meaning of the words employed is most important, for such statutes are not to be extended by implication." In *United States* v. *Field*, 255 U.S. 257, 262, this Court applied the accepted canon that the provisions of a taxing act are not to be extended by implication, and held the tax there was unsupported by the taxing act relied upon by the

Government. "To supply omissions transcends the judicial function." *Iselin* v. *United States*, 270 U.S. 245, 251.

Tax laws are to be liberally construed in favor of taxpayers. *Burnet* v. *Niagara Falls Brewing Co.*, 282 U.S. 648, 654.

Cases are not controlling that can be differentiated. The court below cited and relied on cases like *Standard Paving Company* v. *Commissioner*, 190 F.2d 330, which cases are clearly distinguishable. *Cf. Bogardus* v. *Commissioner*, 302 U.S. 34, 39, 40.

This petition has not been filed for delay.

CONCLUSION

It is respectfully submitted that there is here presented a proper occasion for the exercise of the supervisory power of this Court.

ALDEN CHARLES PALMER,
TENA LEONORA PALMER,
Petitioners,

By JOHN E. MARSHALL,
Attorney for Petitioners.

June, 1959.

APPENDIX

APPENDIX I

29 T. C. No. 21

Tax Court of the United States

Alden Charles Palmer and Tena Leonora Palmer, Husband and Wife, Petitioners, v. Commissioner of Internal Revenue, Respondent.

Docket No. 41375. Filed October 30, 1957.

FINDINGS OF FACT AND OPINION

Petitioner organized and controlled a corporation to own land and erect houses for sale thereon. To do the actual construction, he organized a limited partnership, of which he was the only general partner and in which his interest was 85 per cent. The corporation contracted with the partnership, by long-term contract, to construct houses for a specified remuneration per house. At the same time, petitioner was a substantial stockholder in a corporation engaged in housing construction under generally similar circumstances. Before the end of the partnership's first taxable year, but at a time when construction in both operations was nearing completion and a profit was indicated for the partnership project as against a loss on the other operation, petitioner caused a new corporation to be formed and for its common and preferred stock to acquire the stock of the corporation and the business and assets of the partnership, after which the partnership was dissolved. A return was thereafter filed for the partnership, in which none of the payments received by it under the contract and none of the expenses incurred by it in the performance thereof were accounted for or reported, but which return was intended to indicate an election to report the contract profits on the completed contracts basis. The new corpo-

ration completed the work under the contract, and in its return for its first fiscal year reported the contract profits *in toto*.

The respondent determined that such reporting of the contract profits did not clearly reflect the income of the partnership for the period of its operation, and on a ratable basis allocated a portion of the said profits to the partnership as its income for the taxable period covering its existence and operations. Held, that the respondent did not err in his determination of partnership income under the contract. *Standard Paving Co.* v. *Commissioner*, 190 F. 2d 330, affirming 13 T. C. 425.

Alden Charles Palmer, for the petitioners.
Joseph G. White, Jr., Esq., for the respondent.

The respondent determined a deficiency in income tax against the petitioners for the calendar year 1948 in the amount of $76,517.63. The question for decision is whether the respondent erred in determining that $128,090.43 of the profit realized under a certain construction contract completed in the fiscal year ended August 31, 1949, was the income for the taxable period ended August 31, 1948, of a partnership of which Alden Charles Palmer was a partner. The disallowance of a claimed deduction for contributions has been conceded.

Findings of Fact.

The petitioners are husband and wife, and reside at 3255 Palmer Drive, Los Angeles, California. They filed a joint income tax return for the calendar year 1948 with the collector of internal revenue for the sixth district of California. They reported their income on a cash receipts and disbursements basis.

From 1921 through the taxable year, Alden Charles Palmer, sometimes referred to as Palmer or petitioner, was variously engaged as construction superintendent, con-

tractor, builder and subdivider. On August 20, 1947, he caused Santa Anita Square, Inc., a California corporation, sometimes referred to as Santa Anita, to be incorporated. Santa Anita was organized for the purpose of acquiring and developing land through the construction of a housing project thereon, and to that end, it immediately acquired a tract of land, designated as Tract No. 13613, in Los Angeles County. The land was located at or near Temple City, fifteen to eighteen miles from Los Angeles, and in the vicinity of the Santa Anita Race Track.

All of Santa Anita's stock was held by Palmer, members of his immediate family and near relatives. Included were two sons, two brothers, a niece, and the husband of a niece of Palmer. Palmer was president and Santa Anita was at all times under his control and direction.[1] Its address was that of Palmer's home.

For the purpose of doing the actual work of constructing the houses, Palmer, on September 5, 1947, organized a limited partnership under the name of A. C. Palmer & Company, sometimes referred to as the partnership. Palmer was the only general partner, and had an 85 per cent interest therein. The limited partners were Van Dell, his construction superintendent, Cranford, a civil engineer, Green, the architect, and Curry, an attorney. Their respective interests were six, three, two and four per cent, and they contributed cash in units of $1,000 for each per cent of interest received. Van Dell, Cranford and Green were employed by the partnership, receiving salaries of $850, $600 and $500 per month, respectively. Curry was Palmer's attorney.

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[1] The exact ownership and distribution of the stock of Santa Anita Square, Inc., is not shown of record, but it was Palmer's testimony that he had complete control and direction of the corporation from its "initial commencement." At another point in his testimony, and in identifying a certain activity as that of Santa Anita, he explained, "Frankly mysef as president as [sic] Santa Anita Square"

Tract No. 13613 was divided into lots numbered 1 through 160, and pursuant to a resolution adopted by its board of directors on September 29, 1947, Santa Anita applied to the Bank of America National Trust & Savings Association, hereafter referred to as Bank of America, for 160 loans, each loan to be applied to the construction of a house on one of the 160 lots. Among the papers submitted in support of the 160 applications for loans were financial statements of Santa Anita and of Palmer. Also submitted was a letter from A. C. Palmer & Company, the partnership, by Palmer as general partner, to the Bank of America, the Federal Housing Administration, and all concerned, which letter was to confirm that the partnership was to perform and complete the tract improvements and the erection of residences on the tract under a cost-plus contract with Santa Anita Square, Inc., "wherein the construction fee will be payable only at the completion of the project and out of loan funds then remaining and or proceeds from sales."[2]

Thereafter, on October 16, 1947, the Bank of America submitted 160 applications to the Federal Housing Administration, sometimes referred to as Federal Housing, for insurance on the mortgages to be given by Santa Anita to secure the 160 loans applied for, and under date of October 21, 1947, was notified by Federal Housing that the financing as proposed did not qualify for mortgage insurance for the reason that "[w]aiver of contractor's construction fee until the tract is sold out constitutes secondary financing and therefore is contrary to the Administrative Rules and Regulations."

Under date of October 27, 1947, Santa Anita, in a letter signed by Palmer as president, requested the Bank of America to resubmit the applications to the Federal Hous-

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[2] We find nothing of record to indicate the amount of the fee or "plus" part of the amount to be paid for the work to be done under the agreement.

ing Administration for firm commitments of mortgage insurance on the first 46 cases, Lots 1 through 46, and for conditional commitments, for the balance, Lots 47 through 160; and that in making such renewal of applications, to "[e]liminate entirely the proposed agreement between mortgagor and the builder relative to delayed payment of builder's fee."

In keeping with that request, and by a letter also dated October 27, 1947, the Bank of America wrote the Federal Housing Administration for firm commitments on mortgage insurance for the first 46 applications and conditional commitments as to the rest.

Thereafter, and under date of October 29, 1947, Santa Anita and the partnership entered into a contract, whereby the partnership, referred to therein as the contractor, was to build for Santa Anita 160 houses on the 160 lots in Tract No. 13613. Under the contract the partnership was to furnish all of the material and perform all of the work shown on the drawings and described in the specifications prepared by Green, architect for the owner. The remuneration to be received by the partnership was separately stated and in a fixed amount for each house. By the terms of the contract the project was "segregated into four parts or groups", and the construction work was to be "commenced and prosecuted in each of the several groups if, as and when" Santa Anita should direct. The first group included Lots 1 through 46, and the contract prices for the work the partnership was to do in the building of the 46 houses in that group were in a total amount of $410,842. The second group consisted of Lots 47 through 101, and the total price to be paid for the building of the houses on the lots in that group was $490,491. Group 3 consisted of Lots 102 through 130, and the prices to be paid for the construction of the houses in that group were in the total amount of $259,314. The fourth group consisted of Lots 131 through 160, and the prices to be paid for the construction of the

houses in that group were in the total amount of $267,737. The prices to be paid if all of the houses in the four groups were constructed were in a total amount of $1,428,384.

Work on each group was to be commenced by the partnership within thirty days after written notice from Santa Anita. The prices per house as stated in the contract were to be applicable only for the particular group, or groups, as to which the partnership should be authorized to commence work within four months from the date of the contract, and where work on any group, or groups, was not authorized within that time, the prices, at the option of the partnership, were to be renegotiated to reflect any increased cost of labor or materials. And if Santa Anita should fail to agree to such renegotiated prices, the partnership could, at its option, terminate the agreement as to all or any of the groups for which authority to commence construction had not been given within four months of the date of the agreement.

Payments on account were to be made by Santa Anita on or about the tenth day of each month, the amount of the payment required being 100 per cent of the contractor's cost of labor and materials incorporated in the work and all materials suitably stored at the site thereof up to the last of the preceding month; less the aggregate of previous payments. Final payment was due thirty-five days after the substantial completion of the work, and it was provided that upon written notice that the work was ready for final inspection and acceptance, Santa Anita should make inspection promptly, and if the work was found to be acceptable, it was to issue promptly a final certificate that the work had been completed and had been accepted under the terms and conditions of the contract. Upon the issuance of such final certificate, the entire balance due the partnership was to be due and payable. At Santa Anita's option however, final payment could be made in its preferred stock, at the par value thereof.

The contract also provided that:

If, prior to commencement of work upon any Group or Groups, it becomes necessary or advisable, to the satisfaction of the Owner, to abandon or to suspend for an indefinite period the work upon such Group or Groups, then the Owner, at its option, may terminate this Agreement as to such Group or Groups by written notice to the Contractor, in which event the Owner shall be liable to the Contractor only to the extent of indemnifying the Contractor against actual damages resulting directly from such termination, but the Contractor shall not be entitled to prospective profits on work unperformed or materials unfurnished unless, and then only to the extent that, such materials have been specially fabricated for the work.

Provision was further made that Santa Anita, rather than its architect, was to supervise the work, and that wherever the word "Architect" appeared in the contract or in the general conditions attached thereto, the reference should be held to mean Santa Anita.

The houses were to be two and three bedroom homes, and there were nine different floor plans. The prices Santa Anita was obligated by the contract to pay to the partnership for the construction of the houses ranged from a low of $8,620 to a high of $9,765 per house, with the prices on the great majority ranging between $8,620 and $9,000. According to plans, the houses when completed were to be sold at prices ranging from $11,700 to $14,550 per house.

Under date of November 19, 1947, the Federal Housing Administration, using its appropriate printed forms, advised the Bank of America that it was thereby issuing to it a conditional commitment for "insurance of the mortgage" covering its loan on each of Lots 47 through 160. And under date of November 20, 1947, on similar duly executed forms, it further advised the bank that it was issuing thereby a firm commitment for "insurance of the mort-

gage" covering the loan the bank was making on each of Lots 1 through 29 and Lots 34 through 46 of the said tract.

Thereafter, and under date of December 1, 1947, the Bank of America and Santa Anita executed an instrument designated Owner-Builder Agreement. The agreement recited that the Bank of America had agreed to make 46 loans to Santa Anita in a total amount of $358,600, and that Santa Anita, in consideration of these loans, agreed to construct or have constructed 46 single family residences, one on each of the 46 lots; that the construction should commence not later than thirty days from the date of the agreement, and should be fully completed not later than July 1, 1948, and that the property should be free of liens and all bills for labor and materials paid on or before August 1, 1948. The agreement also provided that the loans should be paid to Santa Anita in five amounts of twenty per cent each of the total loans, the first twenty per cent to be paid when the deeds of trust had been recorded and the final twenty per cent when the building had been completed. Attached to and made a part of the agreement was a schedule showing the amount of the loan against each of the 46 lots and the building to be constructed thereon.

At the instigation or requirement of the Bank of America, Santa Anita, on December 8, 1947, executed an instrument designated Control Agreement with Builders' Control Service, Inc., sometimes referred to as Builders' Control, a loan disbursement agency. The agreement recited that Santa Anita had secured loans in a total amount of $358,600 from the Bank of America, to be used in the construction of a residence and garage on each of Lots 1 through 46, and that the total estimated cost of such construction was $436,762; that Santa Anita would assign to Builders' Control the proceeds of the said loans and would deposit a further sum of $45,000 and a bill of sale for prepaid materials in the amount of $70,421.75, which with

the loan proceeds should make up the estimated cost of construction, plus such additional reserve funds as may have been requested by Builders' Control or the lender; and that Builders' Control would apply the money received as promptly as reasonably possible to payment for labor, services, materials and other items properly incurred as construction costs, and should have the sole option to make payments directly to the subcontractors, laborers and suppliers. There were further and other provisions giving in considerable detail the rights and powers of Builders' Control to supervise the payment of construction costs and to see that moneys received by it were properly applied. Santa Anita agreed to proceed with reasonable diligence in the commencement and completion of construction, and was to receive from Builders' Control any balance of the funds remaining after construction was completed and the costs were paid. Builders' Control was to receive a fee for its services equal to 1½ per cent of the funds disbursed by it for construction.

Also under date of December 8, 1947, the partnership executed a waiver of any and all "lien rights" it then had or might acquire against Lots 1 through 46, and expressly released Builders' Control from any obligations to pay to it any sums for its services "as Superintendent, or otherwise."

The first foundations for houses in Group 1, Lots 1 through 46, were started during December of 1947, and by the end of that month Santa Anita had started its campaign to sell the houses under construction and to be constructed.

As listed by Builders' Control, but with dates not shown, its first two disbursements under the Control Agreement were advances of $10,000 and $15,000 to the partnership, to be used as a revolving fund in connection with the construction work it was to do under its contract with

Santa Anita. This was followed by a disbursement of $10,000 to the partnership, which disbursement was described as "Payroll Advance."

Beginning with December 22, 1947, and at varied intervals thereafter, the partnership would submit statements to Builders' Control covering its disbursements for materials in connection with the construction of the houses and would receive reimbursement therefor from Builders' Control. Also at varied intervals, Builders' Control, according to its statement of disbursements, would make a "Payroll Reimbursement" to the partnership.

Under date of March 1, 1948, the Bank of America and Santa Anita executed a so-called Owner-Builder Agreement, relating to Lots 47 through 101. This agreement, in material respects, was similar to that executed under date of December 1, 1947, with reference to Lots 1 through 46. The loans on Lots 47 through 101 in total amount were shown as $437,500. Construction of the houses on the said lots was to commence not later than thirty days from the date of the instrument. They were to be completed not later than July 1, 1948, and by August 1, 1948, were to be free of all liens and all bills for labor and materials were to have been paid. The loan proceeds were to be paid 40 per cent upon the recording of the deeds of trust and 15 per cent each (1) when the floor joists were in place, (2) when the roof was on and plumbing and electrical work was roughed in, (3) when "plastered inside and out", and finished lumber, sash and doors were on the grounds and (4) when the houses were completed, and the work approved by the Federal Housing Administration.

Under date of March 4, 1948, a Control Agreement relating to Lots 47 through 101 was executed by Santa Anita and Builders' Control, which agreement was in terms similar to that which had been signed with reference to Lots 1 through 46. In addition to the net loan proceeds

Santa Anita was to deposit with Builders' Control the further sum of $15,000 and a bill of sale for prepaid materials in the amount of $21,359.84. Under the same date the partnership executed a waiver of any "lien rights" it had or might acquire against the said lots, and released Builders' Control of any obligation to pay it for services "as Superintendent, or otherwise."

Previously, under date of March 1, 1948, Santa Anita had executed an assignment to Builders' Control of the first $25,000 of cash proceeds from the sale of Lots 71 through 101 and the improvements thereon, less costs of sale, the said $25,000 to be disbursed by Builders' Control pursuant to the terms of the Control Agreement. It was further provided that upon satisfaction of the provisions of the Control Agreement the assignment should be null and void.

The first foundations for the houses in Group 2, Lots 47 through 101, were started during March of 1948.

By letter dated March 19, 1948, Santa Anita authorized the partnership to furnish specified extras to the construction contract between them dated October 29, 1947, at an added cost of $300 per house, making an aggregate added cost therefor of $48,000. In addition, the allowance for lighting fixtures was increased from $50 per house as provided by the contract, to $75 per house, or an added aggregate increase of $4,000.

Under date of June 10, 1948, the Bank of America and Santa Anita executed a so-called Owner-Builder Agreement relating to the remaining Lots 102 through 160. The terms of the agreement were in pertinent respects similar to the terms of the agreement dated March 1, 1948, and covering Lots 47 through 101. The loans to which the Bank of America was committed were $471,500 in total amount. Construction was to be commenced by July 10, 1948, namely, "not later than 30 days from the date" of

the agreement, and was to be fully completed not later than September 4, 1948; and further, the property was to be free of all liens and all bills for labor and materials were to be paid on or before October 1, 1948.

A Control Agreement relating to Lots 102 through 160 was executed by Santa Anita and Builders' Control under date of June 14, 1948, which agreement in pertinent respects was similar to the Control Agreements executed with reference to the other lots. In addition to the net loan proceeds, Santa Anita was to deposit with Builders' Control the further sum of $45,000. Concurrently, the partnership executed a comparable waiver of any "lien rights" it had or might acquire against the said lots and a release of Builders' Control of any obligation to pay it for services "as Superintendent; or otherwise."

By an instrument also dated June 14, 1948, Santa Anita assigned to Builders' Control all proceeds from the sale of Lots 102 through 160 and the improvements thereon, less the costs of sale, the said proceeds to be disbursed by Builders' Control pursuant to the Control Agreement. It was further provided that upon satisfaction of all provisions of the Control Agreement the assignment should be null and void.

The foundations for the houses in Group 3, Lots 102 through 130; and in Group 4, Lots 131 through 160, were started in June of 1948.

The Lovedahl Construction Company, an Oklahoma corporation, was incorporated November 5, 1947. Its stock as originally issued was as follows:

Shareholder	Shares of $100 Common Stock	Shares of $100 Preferred Stock
Mr. and Mrs. L. R. Lovedahl	10	26
Alden Charles Palmer	5	150
A. C. Palmer, Jr.	1	24
Richard J. Palmer, in trust	1	9
William B. Palmer, in trust	1	9
The Gustaveson Company	1	48

As originally planned, the Lovedahl Construction Company was to engage in housing construction in Oklahoma City. Due to an adverse zoning regulation, however, that plan never came to fruition, and when organized the Lovedahl Construction Company was to build housing projects in Stillwater, Oklahoma, the seat of Oklahoma A&M College. Control of operations was primarily in the hands of Lovedahl. The petitioner had to do more with the financing and served in an advisory or consulting capacity.

As in the case of the Santa Anita venture, the acquisition or ownership of the property itself was in a separate corporation, College Homes, Inc., organized for the purpose under the laws of Oklahoma. Except for "a little common stock" acquired by two other persons, the stock of College Homes, Inc., was owned by petitioner and by Lovedahl and his wife.

The Stillwater project was an apartment project, and was approved by the Federal Housing Administration to supply rental housing. In planning and for construction purposes the operation was divided into nine separate projects, each one to be financed and constructed separately. By the summer of 1948, three of the projects were under construction and the Lovedahl Construction Company was obligated to carry them to completion. At the time these three projects were "filed of record" the petitioners, Palmer and his wife, personally obligated themselves as "indemnitors" for College Homes, Inc., "to the tune of about $51,000."

Lovedahl, who was managing the operations of Lovedahl Construction Company, suffered a nervous breakdown, and petitioner found it necessary to take over. On July 24, 1948, he and his sons purchased the common and preferred stock of Lovedahl and his wife for cash, the petitioner acquiring seven shares of the Lovedahls ten shares of common stock and all 26 shares of the preferred stock, the remaining shares of common stock being acquired one share by Alden Charles Palmer, Jr., one share in trust for Richard J. Palmer, and one share in trust for William Buddy Palmer. After the purchase of the Lovedahls' stock, the name of Lovedahl Construction Company was changed to A. C. Palmer Construction Company, sometimes referred to hereafter as Oklahoma Construction.

At or about the same time the construction company stock was acquired, petitioner also acquired the Lovedahl stock in College Homes, Inc., after which he owned all of the College Homes stock except the few shares of common stock outstanding with the two other persons "who were in the deal originally."

When petitioner acquired the above stock from the Lovedahls and took control of operations, the first project consisting of four buildings, containing 24 apartments, was probably 75 per cent complete. As to that project, the apparent result was that there was a loss, but the extent of the loss was not known. As to the next two projects, construction in some if not all instances had reached foundation level. It was also apparent that if all nine projects were to be built, changes in construction designs would be necessary if they were to stay within the limits of cost commitments. The readily available labor supply was inadequate and it was necessary to pay premium wages for some key personnel and mechanics. Shelter had to be provided in some cases. Petitioner found it necessary in one instance to transport plasterers from Los Angeles to Stillwater "in

order to proceed." And there were instances where subcontractors refused to stand by their original bids.

In organizing College Homes, Inc., petitioner and Lovedahl had had no intention that College Homes should enter into the business of owning and renting the said apartments upon their completion. Their intention and purpose was that College Homes would sell the projects as completed to Oklahoma A&M College, to be used by it as rental housing for students, members of its faculty and possibly other college personnel. There were conferences from time to time attended by petitioner, the Lovedahls, the president of the college and possibly Federal Housing officials, at which it was petitioner's understanding that the college would acquire the projects one by one on a self liquidating basis." There was no contract to purchase or agreement as to the terms of purchase or of the price to be paid, but petitioner was told by the president that "they would arrange negotiations to acquire the property", although it later appeared "they were going to negotiate or they were going to attempt to negotiate on their own basis."

From the building trade standpoint, the project at Stillwater was over-developed. The first project was completed early in November of 1948, at which time College Homes, Inc., was able to rent only eight of the 24 apartments.[3]

On some undisclosed date or dates, petitioner discussed income tax problems which might result from the Stillwater and Santa Anita projects with tax counsel. One matter which was discussed was whether a profit on the Santa Anita venture might be offset against a loss on the Oklahoma venture. Following or as the result of these discussions, petitioner approached the limited partners of

[3] We find nothing of record to indicate that College Homes did or did not sell or otherwise dispose of the completed projects

of the partnership, and on August 31, 1948, acquired their partnership interests for cash equal to the payments which had been made by the limited partners therefor. In acquiring these interests, the petitioner had prepared and made no accounting to the limited partners of the then financial condition of the partnership. He did complain of the condition of the projects at Stillwater and of the resulting effects it might have on his individual financial condition, and he may have told Green that he feared a possible loss in Oklahoma and if he went bankrupt he wouldn't want his other partners involved. Curry, one of the limited partners, had been advised that the partnership had "incurred expense and not income, with the result that as of that date it showed a loss." He knew that petitioner, "as the general partner, had it wholly within his control to continue or discontinue the partnership." These factors had some bearing on his sale of his limited interest to petitioner, although the most "potent" factor in his mind "was the fact that it appeared that there might be a conflict" between his interest as a partner and his representation of petitioner as an attorney.

On the next day, September 1, 1948, A. C. Palmer & Company, a California corporation, sometimes referred to as Palmer & Company, was organized, whereupon the original stock of the corporation was issued as follows: 200 shares of common stock to petitioner, for the assets of the partnership; 1,520 shares of preferred stock to petitioner, for his stock in Oklahoma Construction; 207 shares of preferred stock to Alden Charles Palmer, Jr., for his stock in Oklahoma Construction; 77 shares of preferred stock, in trust, for Richard J. Palmer, for stock in Oklahoma Construction similarly held in trust; 77 shares of preferred stock, in trust, for William Buddy Palmer, for stock in Oklahoma Construction similarly held in trust; and 414 shares of preferred stock to the Gustaveson Company, for its stock in Oklahoma Construction. After the

transfers. Oklahoma Construction was wholly owned by Palmer & Company.

By September 1, 1948, 80 of the houses in the Santa Anita project had been completed and notices of completion filed. This included all 46 houses comprising Group 1. Deposits had been received on 127 houses. Sales escrows had been opened on 93 houses, and had been closed on seven. All of the remaining houses were under construction. There were none in respect of which the foundations had not been completed, and approved by Federal Housing, and on all construction had progressed to such point as to permit completion within three to four months.

A major objective, if not the major objective, in the organization of Palmer & Company and in its acquisition of the business of the partnership, including the construction contract with Santa Anita, and its acquisition of the outstanding stock of Oklahoma Construction was the offsetting, for income tax purposes, of the loss of Oklahoma Construction on the Stillwater projects against the profit on the Santa Anita project.

Construction of all homes in the Santa Anita project was substantially completed and the last notice of completion was filed on December 3, 1948. The last notice of completion had been recorded in the public records of Los Angeles County by the end of 1948. The number of homes actually constructed was 159, instead of 160 as originally planned. During 1948 the one hundred thirty-fifth sales escrow on the Santa Anita project was closed, reflecting gross sales of $1,360,872. The last of the 159 houses was sold by Santa Anita in February of 1951.

The six remaining projects which had been planned for Stillwater were never started. They were canceled on January 13, 1949.

On June 20, 1949, Santa Anita wrote Palmer & Company ordering and authorizing certain extras relating to

bathrooms, halls, kitchens and breakfast rooms for the entire tract and for complete change of models for Units 3 and 4. For such extras, Palmer & Company was to receive $31,500, against which a credit of $9,045, for the omission of construction of a house on Lot 130, was to be applied, leaving $22,455 as the net amount payable for the extras so ordered.

Inclusive of the extras and revisions ordered under dates of March 19, 1948, and June 20, 1949, the total price Santa Anita was obligated to pay under its contract of October 29, 1947, for the construction of 159 houses which it built for Santa Anita was $1,502,639. The cost to the partnership and Palmer & Company in carrying out the contract and supplying the extras was $1,287,829.67, resulting in a gross profit of $215,009.33. The addition of insurance refunds and other discounts earned increased the profits to $223,813.86, while a loss on equipment used on the project in the amount of $1,050.12 brought the final gross profit under the contract, inclusive of the extras ordered, to $222,663.74. The total overhead, exclusive of officers' salaries, was $50,520.29, and after allowing for overhead in that amount, there was a net profit under the contract and in respect of the extras ordered of $172,143.45.

As of November 10, 1947, the petitioner had estimated that Santa Anita's gross sales from the 160 houses planned for the tract would amount to $1,933,650. Its actual gross sales from the sale of the 159 houses built were $1,924,760.

As shown by its books, the paid-in capital of Santa Anita as of September 25, 1947, was $30,000 for common stock and $130,000 for preferred stock. The amount shown as paid in for preferred stock was increased to $150,000 at October 3, 1947, and to $190,000 at March 31, 1948. The amount shown as paid in for preferred stock was reduced by retirement of such stock to $175,000 at June 30, 1948; to $125,200 at July 31, 1948; to $85,000 at August 31, 1948;

to $75,000 at January 31, 1949; to $25,000 at May 19, 1949; and to zero at May 31, 1949. The amount shown as paid in for common stock continued at $30,000 until August 1, 1950, when it was shown as reduced to $8,500, by retirement of such stock.

After the transfer of the partnership assets and business to Palmer & Company for its common stock, the first, and its only return was prepared and filed for the partnership purporting to cover the partnership operations for the entire period of its existence, namely, the period from September 5, 1947, the date of organization, through August 31, 1948, the date of dissolution. In the return so filed the partnership did not account for or report any of the payments it had received on account under the Santa Anita contract during such period, and it did not claim as deductions on the return any of the expenses it had incurred during the period in its operations in performance of the contract and shown as such on the partnership books. As so filed, the return was intended to indicate that the partnership had elected to account for and report the results of its operations under the Santa Anita contract by the so-called completed contracts method of reporting contract profits, thereby leaving Palmer & Company to report the profits *in toto* for the year in which performance under the contract should be completed as to the houses in all four groups. The only item reported on the return as gross income was $2,178.79, described as cash discounts earned. A loss of $118.90 on the sale of a table saw was claimed, which with other deductions in a total amount of $19,649.32 disclosed a reported net loss of $17,589.43. The $19,649.32 was made up of varied amounts described as repairs, social security taxes, depreciation, insurance expenses, auto expenses, stationery and printing, professional fees, office expenses, telephone and telegram, utilities, licenses and permits, miscellaneous expenses, and blueprints, plans, etc. There was no disclosure on the re-

turn as to the operation to which the deduction items so claimed were related. The partnership balance sheet for August 31, 1948, as set out in the return, reflected, among other items, an asset of $961,900.42, described as Construction in Process, $20,432.29 as Reserve for depreciation, $92,899.79 as Advances to Joint Venture,[1] Cash of $18,867.90, and total assets of $1,096,471.34. The balancing amount under liabilities was shown as consisting of $2,713.66 as withholding taxes, $1,091,757.68 as notes and mortgages payable, and a net amount of $2,000 as Partners' capital accounts.

For the fiscal year ended August 31, 1949, Palmer & Company, with its subsidiary corporation Oklahoma Construction, filed a consolidated return on November 14, 1949. In arriving at a reported net income of $1,601.59, it took into account the loss of $170,156.29 sustained by Oklahoma Construction and the total profits under the October 29, 1947, construction contract between Santa Anita and the partnership, which contract had been acquired by Palmer & Company on September 1, 1948, as a part of the assets of the partnership paid in by petitioner for 200 shares of Palmer & Company's common stock. In reporting the profits on the Santa Anita construction, it included the extras and revisions authorized by Santa Anita under dates of March 19, 1948, and June 20, 1949. To arrive at the net profit under the said contract, including such extras and revisions, it deducted the expenses and costs which had been incurred by the partnership on the Santa Anita project for the period ending August 31, 1948, as well as

[1] There is some indication of record that the partnership, in a joint venture with another of petitioner's corporations, A. C. Palmer Construction Company, a California corporation, was also engaged in the construction of streets, sidewalks and other improvements in the Santa Anita project, but if so, there is nothing of record to indicate or show just how, when, or by whom the results of such joint operation were reported for income tax purposes. In any event, no such operation is in any way involved in or related to the question here.

the expenses which it, Palmer & Company, had incurred from and after September 1, 1948.

In his determination of deficiency, the respondent allocated the profit realized under the construction contract with Santa Anita in part to the partnership for the period ended August 31, 1948, and the remainder to Palmer & Company for the period from and after September 1, 1948. In making this allocation, he first arrived at a total gross income of $222,663.74, which included the profits on the extras and revisions authorized by Santa Anita under dates of March 19, 1948, and June 20, 1949, which gross income was in the same amount as had been reported by Palmer & Company on its consolidated return for the fiscal year ended August 31, 1949. He next eliminated the profits realized by Palmer & Company on the extras it had been authorized to furnish under the authorization of June 20, 1949, and to which the partnership had never been a party, leaving a net profit, after such elimination, of $168,930.14. The total cost to the partnership and to Palmer & Company in carrying out the contract, exclusive of the extras ordered by the letter of June 20, 1949, was $1,268,587.98. Of those costs, he determined that $961,900.42 had been incurred and expended by the partnership up to and including August 31, 1948, with the remainder having been incurred by Palmer & Company from and after September 1, 1948. He next allocated the $168,930.14, being the total net profit under the contract of October 29, 1947, including the revisions ordered under date of March 19, 1948, between the partnership and Palmer & Company on the basis of the ratios of the costs incurred by each, to arrive at $128,090.43 as the profit of the partnership for its fiscal period ended August 31, 1948.

Opinion

Turner, Judge: The general rule for accounting for and reporting income as stated in section 42(a) of the

Internal Revenue Code of 1939, is that "[t]he amount of all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under section 41, any such amounts are to be properly accounted for as of a different period." In section 41 so referred to, it is provided that "[t]he net income shall be computed upon the basis of the taxpayer's annual accounting period * * * in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income." Under these provisions other methods of accounting, including accrual accounting and the numerous variations thereof, as well as cash receipts and disbursements accounting, are recognized so long as in the opinion of the Commissioner the particular method employed clearly reflects the income.

Pursuant to and under the above statutory provisions, the Commissioner has provided by regulation, section 29.42-4 of Regulations 111,[5] that taxpayers whose income

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[5] Sec. 29.42-4. Long-Term Contracts.—Income from long-term contracts is taxable for the period in which the income is determined, such determination depending upon the nature and terms of the particular contract. As used in this section the term 'long-term contracts' means building, installation, or construction contracts covering a period in excess of one year from the date of execution of the contract to the date on which the contract is finally completed and accepted. Persons whose income is derived in whole or in part from such contracts may, as to such income, prepare their returns upon either of the following bases:

(a) Gross income derived from such contracts may be reported upon the basis of percentage of completion. In such case there should accompany the return certificates of architects or engineers showing the percentage of completion during the taxable year of the entire work to be performed under the contract. There should be

is derived, in whole or in part, from long-term contracts may, as to such income, prepare their returns upon either of two stated bases. On one basis, commonly referred to as the percentage of completion basis, the gross income from such contracts is to be reported according to the percentage of completion during the taxable year of the entire work to be performed under the contract. By the other, commonly referred to as the completed contracts method, the gross income under the contract is to be reported in full for the year in which the contract is finally completed and accepted." The right to report contract profits by the completed contracts method is conditioned, however, on an election by the taxpayer "as a consistent practice so to treat such income", and there is the further proviso that "such method clearly reflects the net income." The term "long-term contracts" is defined by the regulation to mean building, installation, or construction contracts covering a period in excess of one year from the date of execution of the contract to the date on which the contract is finally completed and accepted." Both of the above methods of

(Continued)

deducted from such gross income all expenditures made during the taxable year on account of the contract, account being taken of the material and supplies on hand at the beginning and end of the taxable period for use in connection with the work under the contract but not yet so applied.

(b) Gross income may be reported for the taxable year in which the contract is finally completed and accepted if the taxpayer elects as a consistent practice so to treat such income, provided such method clearly reflects the net income. If this method is adopted there should be deducted from gross income all expenditures during the life of the contract which are properly allocated thereto, taking into consideration any material and supplies charged to the work under the contract but remaining on hand at the time of completion.

A taxpayer may change his method of accounting to accord with paragraph (a) or (b) of this section only after permission is secured from the Commissioner as provided in section 29.41-2.

The above two methods have long been established and recognized as proper methods for accounting for and reporting income from long-term contracts. See Article 121 of Regulations 33, promulgated under the Revenue Acts of 1916 and 1917.

accounting for and reporting longterm contract income are forms of accrual accounting and reporting. By the percentage of completion method, the indicated profit under the contract is accrued ratably according to the percentage of completion during the taxable year of the entire work under the contract, while by the completed contracts method, the entire profit accrues in the year in which the contract is completed. On neither basis must there be actual payment or a right to require payment in the taxable year.

The partnership return filed for the period ended August 31, 1948, the entire period of the partnership's existence and operations, did not take into account or report any of the payments which had been received on account under the Santa Anita contract, or any part of the $961,900.42 covering the expenditures which had been incurred in its performance under the contract and carried as an asset item in that amount as Construction in Process. Although it was stated thereon that the return was prepared on a cash basis, it was not a cash basis return, but was a return prepared pursuant to the completed contracts method of reporting contract income, the purpose being that the profits under the Santa Anita contract be reported *in toto* as the income of Palmer & Company for the year all work under the contract should be completed. The evidence shows that all of the houses were completed and notices of completion had been recorded by the end of December of 1948, and Palmer & Company, which had been organized on September 1, 1948, and which as of that date had acquired the assets of the partnership and the stock of Oklahoma Construction in nontaxable transfers, prepared and filed a consolidated return with Oklahoma Construction for the fiscal year ended August 31, 1949, in which, by the completed contracts method, it did account for and report in full the profits under the Santa Anita contract and similarly claimed deductions for the losses sustained by Oklahoma Construction on the Stillwater projects.

Determining that such a reporting of the profits under the Santa Anita contract did not properly or clearly reflect the respective earnings of the partnership and Palmer & Company thereunder, the respondent has allocated the said profits between the partnership and Palmer & Company in such amounts as in his opinion did fairly reflect their respective earnings under the contract. In so doing, he determined that the partnership, for the fiscal period ended August 31, 1948, realized that portion of the total profits under the contract that its costs in performing the contract through that date bore to the total costs, excluding from such allocation, however, both the costs and the profits under the supplemental authorization by Santa Anita to Palmer & Company, under date of June 20, 1949, which was after the date of the filing of formal acceptance by Santa Anita of the work under the contract, and in which the partnership never participated. The apparent effect of this determination was to shift the accounting for and reporting of the income under the contract from the completed contracts method to the percentage of completion method, the other method prescribed by the above regulation for reporting long-term contract income.

It is well settled that a taxpayer may make changes in the conduct of his business and plan and execute his transactions in such manner as will, in respect of operations and transactions thereafter occurring, result in a minimum of tax under the law. On the other hand, it is equally well settled that income is taxable to the earner thereof, and this rule has been declared and applied in cases where contemporaneously with the earning or accrual of income, such income, by prior anticipatory assignment, might belong to or be the property of another. See *Lucas* v. *Earl*, 281 U. S. 111; *Helvering* v. *Horst*, 311 U. S. 112; *Helvering* v. *Eubank*, 311 U. S. 122; and *Harrison* v. *Schaffner*, 312 U. S. 579. The question here, however, is as to the earnings for a period prior to any transfer or assign-

ment, whether anticipatory or fully executed, and is whether a contractor in the process of completing the work under a long-term contract may, by the transfer to another of his or its assets, including the contract, and by the filing of a return for the period ending with the transfer on the completed contracts basis, obviate or be relieved of any and all obligations ever to account for and report, for income tax purposes, the earnings properly attributable to the work done up to the time of the transfer.

That a substantial profit was earned on the Santa Anita contract and much the greater portion of the work done and the expenses incurred in the earning of those profits was done by and were those of the partnership, not Palmer & Company, are all established by the evidence. At or prior to September 1, 1948, 80 of the 159 houses constructed under the contract had been completed and notices of completion had been filed. The remaining houses were in process of construction and in less than four months thereafter they likewise had been completed. The facts further show that the 80 houses which had been completed at or prior to September 1, 1948, included all 46 houses comprising Group 1. The amount of the recompense to be paid by Santa Anita and to be received by the contractor was in a fixed amount for each individual house, and while we are not advised as to the date when all of the payments were finally made, it was on such contract price that Palmer & Company accounted for and reported the profits in the succeeding fiscal year, by the completed contracts method, and there is no claim that the total profits under the contract as so computed were not correct in amount. Also it would follow, we think, that upon completion of the 80 houses in question the costs of construction thereof had likewise become fixed and determined and the profit thereon was then determinable. Furthermore, by the terms of the contract, the construction of the houses was to be by groups, and the obligations of the parties with respect

to the houses in one group were not dependent upon the carrying out of the contract with respect to the other groups. It would thus appear that whatever may have been the case with respect to those of the 80 completed houses which were in the groups not yet completed, the profits on the houses in Group 1 had not only been earned in the period ended August 31, 1948, but, absent the long-term contract, would by an accrual method of accounting have constituted taxable income for such period. The facts further show that not only had a major portion of the physical construction on all of the houses been accomplished by the partnership prior to its termination, but that the costs incurred in the performance of its work under the contract amounted to $961,900.42 out of ultimate total costs for the entire contract of $1,268,587.98. And there is no showing that from a practical or common sense standpoint, or on the percentage of completion basis, the expenditures of the partnership in the course of its operations under the contract could not and did not reasonably reflect the earning of a comparable portion of the total profit. See, in that connection, *Jud Plumbing, Inc.* v. *Commissioner*, 153 F.2d 681, affirming 5 T. C. 127.

Being a long-term contract, the partnership was privileged under the above regulation to account for and report the contract profits on the basis of the percentage of completion during the taxable period of the entire work to be performed under the contract, or, subject to specified conditions, by the completed contracts method. Prerequisite to the accounting for and reporting of such profits by the completed contracts method, however, the partnership must have elected as a "consistent" practice so to treat such income, and that method, when used, must "clearly reflect" the net income. Certainly, on the facts of this case, the partnership had not, and in the circumstances, could not have, established a consistent practice of treating long-term contract profits by the completed contracts method of account-

ing for and reporting its income. At the time of its termination it had not been in existence for quite a full year, and the Santa Anita contract then in process was, in so far as appears, its one and only long-term contract, and when its one and only return was filed, indicating a purpose to account for and report the profits of the said contract by the completed contracts method, the partnership had already been dissolved, its business and assets had been transferred to another entity, and even the power to establish a consistent practice of reporting long-term contract income by the completed contracts method no longer existed. It was in these circumstances that the respondent, having first determined that the completed contracts method of reporting income did not clearly reflect the income of the partnership under the Santa Anita contract for the period of its existence and operations, which clear reflection of income was likewise a prerequisite under the regulation to the use of the completed contracts method of reporting long-term contract income, determined that that portion of the total contract profits which the costs incurred by the partnership in its work under the contract bore to the total contract costs represented the reportable income of the partnership for the period of its operation.

It is the contention of the petitioner, on brief, that the partnership, by reason of unresolved contingencies at the time it was terminated, never received or realized any income under the contract on either a cash or accrual method of accounting, and such being the case, all of the contract profits were as a matter of fact and law the income of Palmer & Company in its fiscal year ended August 31, 1949, during which the work under the contract was completed, and since under the statute income must be accounted for and reported on an annual basis, the respondent may not, under the provisions of section 41, by allocation, require the partnership to report profits for its accounting period ended August 31, 1948, which it did not receive or realize

during such period, but which were the income of Palmer & Company in its fiscal year ended August 31, 1949.

Whether under the law and regulations a taxpayer may or may not account for and report income from long-term contracts by the cash receipts and disbursements method or by an accrual method other than the methods authorized by the above regulation, is of no moment here, since the partnership here did neither. And to say that as a matter of law there is and can be no accrual of long-term contract income so long as there are contingencies which, when resolved, might or could in some degree affect the amount of ultimate profits, would be to hold that the percentage of completion method of accounting for and reporting such income is unsound and without basis in the law. Such method of accounting for and reporting long-term contract income is based on the proposition that as a general rule such contracts move to completion substantially as anticipated and planned by the parties and that the work done in progress toward completion of the entire work reasonably and fairly reflects the earning of a ratable portion of the anticipated ultimate profit, and the accrual on an annual basis of the profits so indicated has long been accepted and established as a sound and proper method for recording and reporting long-term contract income. That is not to say, however, that a ratable accrual of the contract profits would still be required, if there were unresolved contingencies of such character as to render the ultimate collection thereof improbable and unlikely. Not only is there no showing of the existence of such an improbability, but to the contrary, the evidence supports the conclusion that the profits as determined were collectible. For a case wherein variations of the meaning of the word accrued were discussed and one question was as to the accrual of profits on work or business only partially performed as of the end of the taxable period, see *Helvering v. Estate of Enright*, 312 U. S. 636, 642-645.

As supporting his determination, the respondent cites and relies on *Standard Paving Co.* v. *Commissioner*, 190 F. 2d 330, affirming 13 T. C. 425, and *Jud Plumbing & Heating, Inc.* v. *Commissioner*, *supra*. In *Jud Plumbing*, the taxpayer, a corporation, at a time when there had been substantial performance of certain contracts but not completion, dissolved and transferred its assets and business to its stockholders in liquidation. These stockholders took over the operation and completed the contracts and, as in the instant case, in returns filed for the year of completion accounted for and reported the entire contract profits by the completed contracts method. In *Standard Paving*, under comparable conditions, the assets and business, including the incompleted contracts, were transferred by the petitioner corporation to its parent company in a nontaxable reorganization or exchange. The unfinished contracts were thereafter completed by the parent company, which, as in *Jud Plumbing* and in the instant case, accounted for and reported the contract profits *in toto* by the completed contracts method for the succeeding taxable year. In those cases, as in the instant case, the Commissioner, relying on section 41 as his authority, determined that on such state of the facts the completed contracts method of accounting did not clearly reflect the income from the contracts involved, and determined the income of the original contractor for the period prior to the disposition of the contracts, by relating its performance of the contract to entire work under the contract. In both *Jud Plumbing* and *Standard Paving*, the petitioner corporation had been in existence and conducting a long-term contracts business over a period of years prior to the taxable year in question, and for such prior years and as to contracts completed had established a consistent practice of reporting the profits from such contracts by the completed contracts method approved by the above regulation. Even so, however, it was held that with respect to contracts in process of construction the original contracting corporation

could not avoid the tax on the profits earned by its work in the performance of the contract by dissolving, as in the *Jud Plumbing* case, and transferring its assets, including the contracts, to its stockholders prior to completion; or, as in the *Standard Paving* case, by transferring its assets, including the contracts, to its parent company in a nontaxable exchange prior to completion, and that the Commissioner, under the statute, was justified in determining that as to the contracts in question the completed contracts method of accounting did not clearly reflect the income of the transferring corporations and in allocating a ratable portion of the total contract profits to the original contracting corporations as the income earned prior to the said transfers.

It is thus apparent, we think, that in material respects the situation here is the same as in *Jud Plumbing* and *Standard Paving*, and that the rule pronounced in those cases is applicable and controlling here. We so hold. See also Guy M. Shelley, 2 T. C. 62.

In concluding and holding as above stated, we have not overlooked the contract provision which would have permitted Santa Anita to make the final payment under the contract in its preferred stock at the par value thereof. Although the contention is not otherwise developed, there is some suggestion, on brief, that by reason of that provision in the contract, a contrary decision to that pronounced is required. Suffice it to say that there is no showing of record that in the event of such election the stock, on any pertinent date, would have had a value less than par and that the portion or amount of the profits earned through the partnership's performance of the contract would have been in any amount other than that shown and determined herein.

Decision will be entered for the respondent.

Served and Entered Oct. 30, 1957.

APPENDIX II

UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

ALDEN CHARLES PALMER and TENA LEONORA PALMER,

Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

No. 15,907

Apr. 2, 1959

Upon Petition to Review a Decision of the Tax Court of the United States

Before: FEE, CHAMBERS, and HAMLIN, Circuit Judges

JAMES ALGER FEE, Circuit Judge:

There is only one question involved in this appeal from the Tax Court. It was there decided that the Commissioner of Internal Revenue had not abused the discretion granted to him by Section 41 of the Internal Revenue Code of 1939[1] in determining that the method of accounting for and reporting contract income and expense used by a partnership did not clearly reflect its income. Therefore, the Com-

[1] "The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. If the taxpayer's annual accounting period is other than a fiscal year as defined in section 48 or if the taxpayer has no annual accounting period or does not keep books, the net income shall be computed on the basis of the calendar year." 26 USC. § 41, 1952 Ed.

missioner ruled, under authorization of this section and Treasury Regulations, that the income from a construction contract should be reported for taxation under the percentage of completion method.[2] The Tax Court held the determination of the Commissioner was correct.

Alden Charles Palmer organized a corporation, Santa Anita Square, Inc., for the purpose of constructing certain housing projects in California. He controlled the corporation, was its president and, together with his family and relatives, owned all its stock. Thereafter, he organized a partnership in which he was the only general partner, with an eighty-five per cent interest, and the other partners, who were his construction superintendent, a civil engineer, the architect and an attorney, were limited in liability. All limited partners except the attorney drew salaries.

Santa Anita made tentative arrangements, subsequently fulfilled, through a bank for guaranty of loans by the Federal Housing Administration on October 27, 1947. Two days thereafter, on October 29, Santa Anita entered into a contract with the partnership for the construction of 160 houses for a remuneration separately stated in a fixed amount for each house. Monthly progress payments were to be made for one hundred per cent of labor and material costs, with final payment due 35 days after substantial completion of the work.

The construction loans were made available to Santa Anita by the bank under three group contracts, each subject to control agreements with Builders' Control Service, Inc., required by the bank to secure performance in accordance with the loan contracts.

Pursuant to a plan to offset the gains upon the contract of the partnership at Santa Anita for tax purposes against

[2] The completed contract and the percentage of completion methods of reporting income from long term contracts are authorized and described in Regulation 111, § 29.42-4, promulgated under the Internal Revenue Code of 1939.

the losses upon a certain entity in which Palmer had an interest in Oklahoma, he acquired the interests of all the limited partners on August 31, 1948, and the partnership was thereby dissolved.

On the next day, September 1, 1948, Palmer transferred the partnership assets to a California corporation, which he had formed, in return for common stock therein. All the stock in the Oklahoma corporation, which had sustained losses, was also transferred to the new company.

The partnership prepared its only income tax return covering the period of its existence, September 5, 1947, through August 31, 1948. The balance sheet included therein showed an asset of $961,900.48, described as construction in progress. But the return did not reflect any income or disbursements which can be referred to the contract under which the construction was done.

The California corporation filed an income tax return in which, on the "completed contracts" theory, it accounted for and reported in full the profits of this contract at Santa Anita and claimed deductions for losses sustained by the entity controlled by Palmer in Oklahoma.

This case appears quite simple of solution. The technical question is simply one of statutory construction. The provision of the tax law in dispute requires that net income be computed on the basis of the annual accounting period of the taxpayer in accordance with the method regularly employed by him in keeping books, except where "no such method of accounting has been so employed, or if the method employed does not clearly reflect the income." In that instance, it is expressly directed that the computation be made by "such method as in the opinion of the Commissioner does clearly reflect the income."

There is unquestionably a patent difference between a "method of keeping books" and the "method of account-

ing for and reporting income." *Commissioner* v. *Schuyler*, 2 Cir., 196 F.2d 85. This distinction is disregarded in the argument of respondent in reliance upon our opinion in *Daley* v. *United States*, 9 Cir., 243 F.2d 466. This resemblance between that decision and the present situation is in most respects fallacious. It is true it was there held that the method of accounting is a question of fact and that the label placed on a return is not conclusive. But the problem in the *Daley* case was whether the taxpayer could amend the return to show a different method of accounting and return. It was there also said upon the evidence, however, that a "completed contract" basis may be used with either the "accrual" or the "cash" method of determining profit upon the contract.

Here the only matter really raised by petitioner is the method of accounting income under the rule laid down in Section 42(a) of the Internal Revenue Code of 1942,[3] which, of course, refers to the provisions of Section 41 above discussed.

But Palmer, who is not a lawyer, represented himself before the Tax Court. Since the partnership was not in existence in any previous tax year and since Palmer did not introduce the books or avail himself of an opportunity offered to stipulate as to the contents, there was no basis upon which the method of accounting actually used could be established. The Tax Court made no finding as to what the basis was. Palmer failed to establish "the method of accounting regularly employed in keeping the books of such taxpayer."

The argument of the government, which deals only with method of reporting, does not meet the requirements

[3] "The amount of all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under section 41, any such amounts are to be properly accounted for as of a different period . . . ." 26 U.S.C. § 42(a), 1952 Ed.

of the statute. The Tax Court, in adopting this argument in findings, was also inaccurate. The enactment provides that, if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. The basis of the opinion of the Tax Court is that the method of reporting was improper. It should have held that petitioner had failed to prove that any "such method of accounting has been so employed" and therefore the method which would clearly reflect the income in the opinion of the Commissioner should be used to make the computation. The decision of the Tax Court can be affirmed upon this basis.

But there is a much more fundamental matter. Petitioner boldly and somewhat defiantly says not that their books had been kept according to one system or another, but that the partnership did not have this disputed income. There is thus a confusion between method of accounting for income and allocation of income. As was said in *Jud Plumbing & Heating, Inc.* v. *Commissioner*, 5 Cir., 153 F.2d 681, 685:

> "The completed-contract method of accounting determines profits, but it does not always, necessarily and conclusively determine legal rights to those profits, not the tax liabilities thereon. 'Ascertainment of income' is chiefly a matter of accounting. 'Allocation of income' is chiefly a matter of the application of income tax law to basic legal rights. The terms are not synonymous."

The dilemma of Palmer would not be solved whether or not he proved that his method of accounting was on "cash", "accrual" or "completed-contract" basis. The claim that the partnership had no income during its existence is contrary to all the facts in the case.

This partnership contracted with Santa Anita Square, Inc., to build 160 houses at a fixed price per house. This contract was never abrogated or cancelled. It was the same contract which was transferred to A. C. Palmer & Company by the partnership. This was the same contract which A. C. Palmer & Company completed and upon which it was paid a substantial profit.

There is no evidence that the construction contract was ever in abeyance or was a "dormant" or "sleeping contract", whatever is meant by that phrase. Santa Anita was required by its own contract with the bank "to construct or have constructed" the houses. Santa Anita likewise executed with Builders' Control Service contracts governing the disbursements of loan proceeds under which the sales proceeds were assigned until the loans from the bank were repaid. The partnership, because of its contract with Santa Anita, executed to Builders' Control Service a "waiver of any and all lien rights that we now have or may acquire against" Santa Anita. Each time also, the partnership released Builders' Control Service "from any obligations to pay us at any time any sums for our services as Superintendent or otherwise".

If the partnership had had no contract, it would have had no lien rights and there would have been no problem of compensation. Petitioner talks about a novation. But there was no evidence of any such an operation. The bank and Builders' Control Service were fully aware of the contract with the partnership.

The building of the houses progressed during the entire period from the date when the partnership received an advance of $25,000.00, as a revolving fund, from Builders' Control Service under the contract between Santa Anita and the partnership of date October 29, 1947, through September 1, 1948, when the partnership was dissolved. During all this time, the contract with the partnership was in effect. It is claimed the partnership did not perform any

services as contractor under the contract. This was the same contract which was transferred to petitioner and by him transferred to A. C. Palmer & Company, and petitioner received in exchange therefor all the common shares in that corporation.

During the time the houses were built under the contract, profits were earned by the partnership. The assignment was made for the purpose of allowing the corporation to make use of the profits earned on this very contract to balance or wipe out the losses of petitioner on the Oklahoma deal. Substantially, the consideration on the deal went to petitioner. The earnings up to the time of assignment were those of the partnership. Petitioner could not have siphoned off those earnings without paying therefor if the transaction had been between independent persons or entities. This feature makes it manifest that the partnership did earn the income under the contract up to September 1, 1948. The mere fact that the earnings were wrapped up in an entire contract and were not paid over until the contract had been spirited out of the partnership and placed in the hands of a different corporation can not affect the situation.

The partnership was required to report and the partners were required to pay tax upon any income which had been earned during the period of its existence. The fact that a dissolution of the partnership was effected before the end of the taxing period could not prevent its earning and the incidence of income. The argument that the contract was assigned and work completed by a corporation which received compensation for the entire work and thereby the partnership had no income is, to say the least, ineffective.

While *United States* v. *Lynch*, 9 Cir., 192 F.2d 718, *cert. den.*, 343 U.S. 934, related to a different although allied problem, the language and reasoning are so apposite

to the situation at bar that it is adopted to illustrate our solution.

> "The fundamental change in the corporation's circumstances, that is, its liquidation and consequent nonexistence, prevented its accounting technique from achieving the rough matching of expenses and income previously attained.
>
> "We understand appellant to contend that the income in question is not that of the corporation. The answer is, that the corporation has performed the services which create the right to the income which brings into play the basic rule that income shall be taxed to him who earns it. * * * A corporate liquidation and transfer of assets cannot divert taxability of income already earned any more than does an assignment of such income. * * * Appellant further argues that granting there was corporate income it should not be taxed to the corporation because of the peculiar circumstances of this case. However, 'a taxpayer * * * cannot avoid taxes by the simple expedient of not completing its contracts; and where a corporation puts itself in such a position that it could never complete its contracts, it is in no position to insist that even if it had income it has no tax liability.' *Cf. Jud Plumbing & Heating, Inc.* v. *C.I.R.*, 5 Cir., 1946, 153 F.2d 681, 685." *United States* v. *Lynch*, 9 Cir., 192 F.2d 718, 721.[4]

The method chosen by the Commissioner was fair and equitable. The decision of the Tax Court is affirmed.

(Endorsed:) Opinion. Filed Apr. 2, 1959.

Paul P. O'Brien, Clerk.

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[4] This same conclusion under somewhat parallel states of fact has been reached by other Circuits and the Tax Court. *Cf. Standard Paving Company* v. *Commissioner of Internal Revenue*, 10 Cir., 190 F.2d 330, 332; *Floyd* v. *Scofield*, 5 Cir., 193 F.2d 594; *Dillard-Waltermire, Inc.* v. *Campbell*, 5 Cir., 255 F.2d 433; *Carter* v. *Commissioner of Internal Revenue*, 9 T.C. 364.

APPENDIX III

UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

ALDEN CHARLES PALMER and TENA LEONORA PALMER, Petitioners,	)	
vs.	)	No. 15,907
COMMISSIONER OF INTERNAL REVENUE, Respondent.	)	

JUDGMENT

Upon Petition to Review a Decision of the Tax Court of the United States.

This cause came on to be heard on the Transcript of the Record from the Tax Court of the United States, and was duly submitted.

On consideration whereof, it is now here ordered and adjudged by this Court, that the decision of the said Tax Court in this cause be, and hereby is affirmed.

(ENDORSED) Judgment

Filed and entered: April 2, 1959

PAUL P. O'BRIEN, Clerk